DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

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The Honorable Tom Bliley
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Bliley:

Commissioner Rossotti asked me to respond to the letter dated March 23, 2000, from you and Congressman Bill Archer. You asked the Internal Revenue Service (IRS) to quickly resolve the issue of whether interconnection facilities transferred to an electric utility by an independent power producer constitute a taxable "contribution in aid of construction" (CIAC) under section 118(b) of the Internal Revenue Code.

For a corporation, section 118(a) provides that gross income does not include any contribution to the capital of the taxpayer. Section 118(b) provides that the term "contribution to the capital of the taxpayer" does not include any CIAC or any other contribution as a customer or a potential customer, except for water and sewerage disposal utilities.

Notice 88-129 Addresses Interconnection Transfers by a Qualifying Facility to a Utility

Notice 88-129 provides guidance for certain transfers of property to regulated public utilities by qualifying small power producers and qualifying cogenerators (collectively, Qualifying Facilities), defined in section 3 of the Federal Power Act, amended by section 201 of the Public Utilities Regulatory Policies Act of 1978 (PURPA). PURPA requires an electric utility interconnect with a Qualifying Facility to allow the sale of power produced by the Qualifying Facility. A Qualifying Facility must bear the cost of the purchase and installation of equipment required for the interconnection. Generally, the utility takes legal title to the interconnection facilities, which become part of the utility's transmission network. The Notice addresses whether interconnection facilities transferred by a Qualifying Facility to a utility constitute a section 118(b) CIAC to the transferee utility.

The Notice provides a safe harbor, excluding from the definition of a CIAC certain transfers of interconnection facilities to utilities by Qualifying Facilities. The rationale for the safe harbor is that a Qualifying Facility is not a customer that receives services from

the transferee utility under section 118(b) if the transfer of the interconnection facilities is to allow the producer to sell power to its customer utility. Since the Qualified Facility does not receive services from the transferee utility, there is no concern that the property transferred might be a form of prepayment for future services from the transferee. Accordingly, the transfer of the interconnection facilities is not a taxable CIAC to the transferee utility. In past private letter rulings, the IRS has interpreted the safe harbor to apply to similar transfers by producing facilities that were not PURPA Qualifying Facilities.

The IRS Is Deciding Whether to Extend Notice 88-129 for Third Party Sales

The inquiry you and others have recently made raises the question of whether the safe harbor should be extended when the interconnection is transferred to a utility, not to sell power to the utility, but rather, to transport the power over the utility's transmission network for sales to third parties.

Your Transaction Differs from the Notice Transaction

The transaction you describe is materially different from the transaction in the Notice. The transaction in the Notice arises in a regulated marketplace where the Qualifying Facility's power is sold under a long-term power purchase agreement to the transferee utility. The transaction you describe arises in a deregulated marketplace where the producer's power is not sold to the utility but is transported over the utility's transmission lines into a "power pool" where third-party buyers bid on the producer's power.

The IRS and the Treasury Department are considering the proper tax treatment for this type of transaction. Among the issues to be resolved is whether the transferor producer's use of the transferee utility's transmission lines makes the transferor a customer receiving transportation services for purposes of section 118(b).

Constituents Should Forward Comments to the IRS

We encourage your constituents, as well as interested members of the electric power industry, to forward their views regarding this type of transaction to the attention of Gregory N. Doran, Attorney-Advisor (CC:DOM:P&SI:5), in the Office of Chief Counsel, IRS.

I have sent a similar letter to Congressman Archer. I hope the information provided is helpful. Please contact me at (202) 622-4500 if I can be of further assistance; or have a member of your staff contact Gregory Doran, at (202) 622-3153.

Sincerely,

Judith C. Dunn (signed)

Judith C. Dunn
Associate Chief Counsel
(Domestic)